

Current Issues in Political Economy

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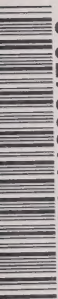
Arthur M. Okun
Robert Solomon

Discussion Paper Series

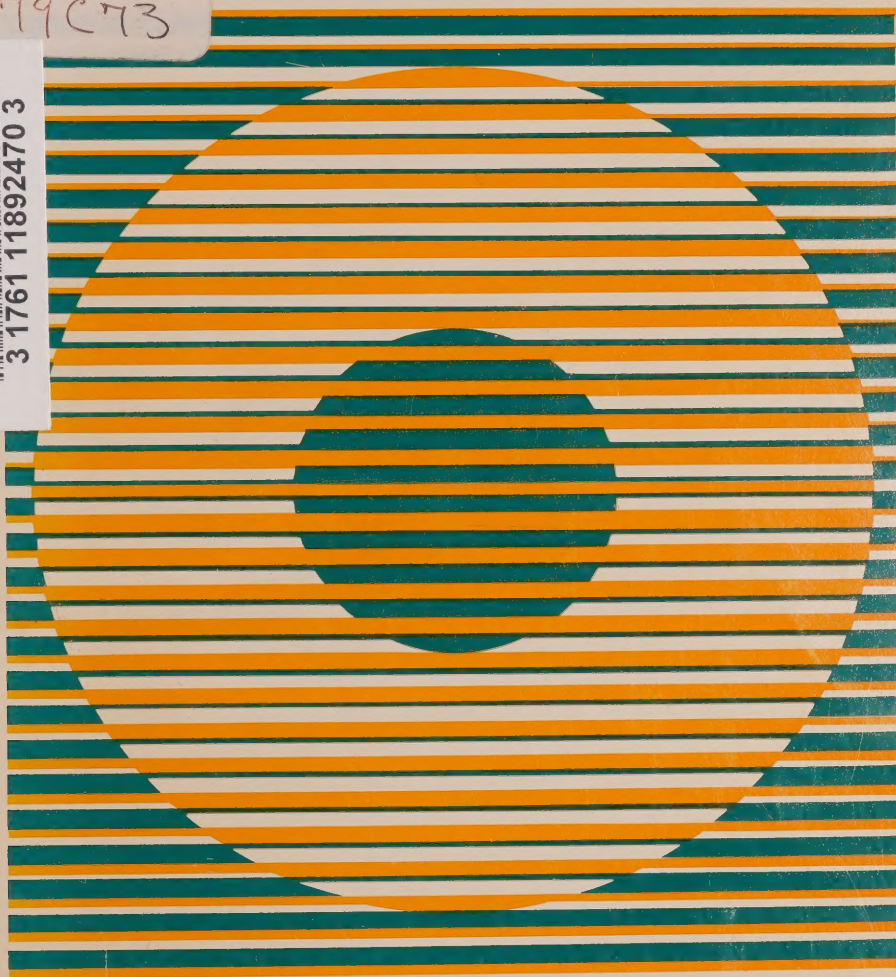
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CURRENT ISSUES
in
POLITICAL ECONOMY

Arthur M. Okun
and
Robert Solomon

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INTRODUCTION

This discussion paper consists of two addresses, 'Political Economy: the lessons of the seventies' by Arthur M. Okun and 'Current Issues in the International Economy' by Robert Solomon, presented to the fifth annual Outlook and Issues Conference sponsored by the Ontario Economic Council at Toronto on 2 April 1979. They are being distributed as a contribution to the continuing discussion of public policy issues in these areas.



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POLITICAL ECONOMY: THE LESSONS OF THE SEVENTIES

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The following is the edited transcript of an address delivered from notes to the fifth annual Outlook and Issues Conference of the Ontario Economic Council, held in Toronto, Ontario, 2 April 1979.

After living with inflation for more than a dozen years I think we have learned something about it. Of course what we have learned depends upon who is doing the talking. Different people have learned widely different things. Here, then, are the lessons that it seems to me we have learned during the inflationary era that has gripped North America and the whole Western industrialized world since the mid-sixties.

We have found that inflation, once it has taken root, has enormous tenacity, much more than ever could have been expected. It proves resistant to slack and recession and excess supply, it tends to carry on by inertia or momentum, and it wants to escalate rapidly upwards even in the absence of widespread excess demand.

In the United States in particular the chronic inflation of the seventies has been unprecedented. It is different from anything experienced before.

For example, every year since 1968 has registered an inflation rate of at least 4 per cent. No year between 1952 and 1965 registered an inflation rate that high. The inflation survived the mild recession in 1970, and that was the first time we ever emerged from a recession with an appreciable inflation rate.

The test of whether the 1970 recession was too mild to cure the disease came in 1974-75 with a severe downturn about twice the intensity of any previous post-war recession. Even that one left us with 6 per cent inflation, higher again than any year between 1952 and 1969.

Now this is something new. Recessions have traditionally sent prices down. They have lowered prices and actually reversed inflation, not just slowed it down. It is clear that in some respects prices and wages have not conformed to the book. Of course at the start of the inflationary era they did. There is no doubt that 1966, 1967, and 1968 marked a textbook example of excess demand inflation: too much money chasing too few goods.

Unfortunately, there can be no question of the federal government's policy errors at that time. The methods used to finance the Vietnam war made the federal budget an engine of inflation, and monetary policy was enlisted to support that inflation. Those were serious over-stimulative errors of policy in the context of war.

But every war has produced excess demand and found government policies inadequate to contain inflationary pressures generated by rapidly growing war expenditures. What was different this time was that peace did not bring an end to inflation. I do not accept the original sin theory that because Lyndon Johnson did not raise taxes in 1966 the United States was thrown out of the Garden of Eden.

But if the sixties were from the textbook, the seventies were not. Excess supply is supposed to bring prices down. It did so in areas where prices were set the way the textbook says they are. Prices set in auction markets, commodity exchanges, and the like fell 10 per cent. They did not just slow down; they actually fell 10 per cent between spring 1974 and spring 1975.

Incidentally, those organized exchanges are exactly where there ought to be a good reading of expectations. It seems very hard to argue that what was wrong elsewhere in the economy had to do with a belief that inflation would continue when the very place with the most sensitive reading of expectations, the markets that clear every single day, showed declining prices during the severe recession.

Elsewhere in the economy prices kept rising, for reasons that really cannot be explained except in terms of the nature of the price- and wage-setting mechanism. Copper and steel are

both products that come out of mines and are relatively labour-intensive. Yet copper prices fell and steel prices kept rising through the recession and the early recovery.

There are administered prices covering most of our economy. They are basically cost-oriented, being made by adding a markup to cost. I do not believe such cost-oriented, administered prices are an evil manifestation of monopoly. The corner jeweller prices on a cost-markup basis, and there is no barrier to entry into that industry.

Rather, the cost-orientation of prices really represents a kind of efficient adaptation of society to a complex, interdependent economy where customer-supplier relationships are important, where businessmen really are looking for customers, where they can keep customers by treating them fairly, and where treating them fairly means charging them cost plus a markup. In that world in a slump there is no great incentive for a businessman to search for bargain-hunters. He knows that if he finds them he will not be able to hold onto them when times improve.

But there are equally incentives to keep a businessman from trying to strong squeeze out the last penny during a situation of strong demand. Cost-oriented markup pricing does hold down inflation in its early stages. It makes inflation slow to start but also slow to stop.

In labour markets that is all the more true. A queue of applicants at the hiring gate does not provide the firm, even the non-union firm, with an opportunity to say, 'Take a pay cut, or there are all those folks out there who want your job.' There are employer-employee relationships to protect. There are investments by both employer and employee in each other and in the job. Costs have been incurred for training and experience that will pay off for both parties only if the worker continues to work for the same employer. And this clearly requires the kind of personnel policy and personnel relationship, whether union or non-union, that looks to the long run and is responsive to the danger that a wage policy that takes advantage of a weak labour market will only secure a high quit rate and rapid turnover the next time the labour

market tightens.

So there are firms with 'No Help Wanted' signs, queues outside, and people on layoff but still raising wages with no union to force them. I think an efficient institution has developed in our labour market to promote career relationships between employers and employees. It is a terribly important thing to have that sense of fairness, that sense of wages following wages, wages following the cost of living, wages being relatively insensitive to the labour market. But it does make inflation very hard to uproot once it has got started.

Over the post-war era, North American institutions have come to take the dollar very seriously. We use dollars as our score-keeping system, our planning and our costing systems, our means of setting prices. There is only one objective way for a business to find a cost, and that is to see what it paid for somethings. That cost has to be backward-looking, because historical costing is the only kind of measure an accountant can deal with. If wages are going to follow wages, they are going to follow dollar wages.

That is perfectly reasonable in the kind of world that gave us low inflation rates. But it becomes inappropriate in an inflationary world. When people saw that the world had become inflationary, that even recessions had not driven inflation out, a whole set of adaptations were made by institutions.

We found not only a shift to so-called LIFO inventory accounting but also a shift to LIFO pricing. Firms that had always put the price-tag on an item when it came in and sold it at that price began to change their habits. Catalogues defining prices over a long period of time, such as a full year, became a set of picture books with a separate price list issued every month, if not every week. The automobile pricing system, which was always keyed to a model year, now changes monthly and weekly. Firms that had been prepared to take fixed-price orders for goods a year or two in advance, or in some extreme cases like Westinghouse even decades ahead, abandoned those practices. They could not tell their customers

very much ahead of time the price at which they would ship a product.

We began to index. With cost-of-living escalators and with even prices, as on the Alaskan Pipeline, being geared to the cost-of-living, the index, for all its mortgage and medical care weights and so forth, has become a better yardstick than the dollar. But when we index we are just guaranteeing that the inflation that gets into any part of the system spreads through it all the faster. Every such adaptation to inflation really speeds up the inflationary process.

These, I submit, are diseases, not cures. There is no way that a society can index itself as a whole. Indexing is a process by which some prices are going to keep up with inflation, make the inflation go faster, and push other prices and wages further behind.

The business sector has seen repeated attempts to narrow this gap between historical cost, the only cost you can measure, and replacement cost, the only cost that counts. Any narrowing of that gap means a widening of markups and hence another kind of ratcheting of inflation.

Adaptations to inflation have been an important reason why we keep getting accelerating inflation at lower and lower flashpoints. By any standard, in 1978 and the first part of 1979 operating rates and unemployment rates in the United States have not been as tight as they were in early 1973 when the flashpoint occurred in the last round of inflation.

But we are being propelled by these adaptations, by these catch-ups, which keep pushing the inflationary spiral. If one looks at the entire period of this expansion, from March 1975 in the United States until now, it is a wage-price spiral inflation. Or it's a wage-wage spiral inflation, or it's a price-wage spiral inflation, or it's a price-price spiral inflation. But it is not an inflation based on specific factors. It is true that in recent months food and fuel have been troublesome, and back in 1973-74 they were especially troublesome. But they have not outpaced the over all cost-of-living indexes since the spring of 1975.

The special factors causing inflation are just two: wages

and prices.

Even the present threat of further OPEC price increases and extra drains on purchasing power for oil-importing countries like the United States is of larger significance in terms of what it would do to the wage-price spiral. The additional inflation that comes from oil prices getting into wages, getting into other industrial products, is really a much larger force in our society than what we hand over to OPEC in tribute when the price goes up.

A number of economists in 1974 argued that oil price increases could not be inflationary. After all, if some prices went up, other prices had to come down, as long as the money supply was held constant. I don't hear anybody saying that any more. We have at least learned one thing - that that was dead wrong. The particular price increases associated with oil did have a major impact on the price level, and they did so by getting into the wage-price interaction.

Not only has inflation shown this tenacity, this stubbornness, this inertia, but it has also had enormous social, economic, and political costs. They, of course, are not separate from the inflationary process itself. The descriptive economics of inflation really tells the story of the normative economics, the welfare economics, of inflation. It is the search for fairness that accounts for the wage-price spiral and markup pricing. It is the question of fairness that produces the enormous social disruption that goes along with inflation. Everyone in the wage-price spiral has a feeling of being on a merry-go-round, seeing only the person in front and always chasing. No one thinks he's in front; everyone feels behind. Everybody naturally concludes: 'I have the short end of the stick - somebody's got the long end.' The biggest new growth product of the seventies has been a stick with two short ends. It is very difficult to find where the long end has been.

But there really is a relative price shift - inflation is not uniform - and changes in relative prices again really reflect the nature of those wage-making and price-making institutions. In price-making institutions that are very

sluggish, as in public utility regulations, prices lag behind. The auction items go ahead. The union sector has done much better in protecting workers against the ravages of inflation than the non-union labour market has. In the United States union wage increases have averaged almost a full point more than non-union wages through the decade of the seventies. Incidentally, things went a little in the opposite direction in the sixties, when non-union wages were actually outpacing union wages.

In asset markets, savers have no way of hedging against inflation. The one hedge the world has offered them is the single-family home, which has usually been a great investment. But it does impose lumpiness: large transactions for a few people, a shortage of liquidity for many. People with balance sheets that look exceedingly good because of their single-family homes, but with enormous cash drains in the form of their monthly mortgage payments, long for the good old days when they could put their money into the savings bank and get a reasonable deal.

But today before-tax returns from most forms of saving available to the small saver are not very good, and their after-tax yield is terrible. In the process we have undermined the whole planning, costing, scoring system with the dollar as the yardstick. The way in which contracts and informal understandings take place, these adaptations, this search for a new yardstick, this indexing process, is really a groping for a new language and a new system. Anyone who sees the cost of changing to the metric system, where there are some ultimate advantages, ought to recognize that changing from a dollar-yardstick system to another system is even more costly. The dollar has been even more strongly built into the institutional structure.

What people object to is not a sense of money illusion, as some economists insist. Rather, some economic models build a world based on barter illusion, as though money did not matter, as though there were no contracts and practices geared to a currency unit. But there are. People now recognize the distortions of a money economy that come from inflation.

The inflation doves throughout the decade have been wrong on two counts: that inflation would simmer down and that people would learn to live with it. Frankly I think the greatest mistake many American liberals made in the seventies was to be soft on inflation, to refuse to face up to it, to refuse to pay the costs of dealing with it.

But if there have been serious mistakes by the Keynesians and the liberals, there have also been serious mistakes by conservatives, monetarists, and the like. The people most optimistic in 1975 about inflation vanishing from the system were the monetarists. We had paid the price; we had taken the cure; therefore virtue was ours, and the Lord was bound to reward us with the elimination of inflation. Now we are told we did not take enough of a cure. But at that time the greatest optimism about inflation was coming from the monetarists. The whole foundation of the so-called rational expectations approach to economics is that as soon as people learn to adjust to inflation, it cannot hurt them. Expected inflation is costless in that model of the world, which analytically is one of the most dovish approaches of all. But those economists, perhaps because they hang out with the right company, have barely noticed those implications of this theory.

What have we learned about curing inflation in this decade? First, we've learned that although there is a fiscal-monetary cure, taken alone it is economically inefficient and politically intolerable. We have had a pretty complete track record by which to judge. The record of the last recession suggests that in the United States each point of relief from inflation, each point we roll back the inflation rate through unemployment, costs us about \$200 billion of real production. In Canada I suspect that by knocking off the traditional zero we'd get about as reliable an answer. But whether it is \$200 billion a point for the United States or \$20 billion a point for Canada, it's a very big sum, and as Charles Lamb said, that's burning down the house to roast the pig!

To talk about reducing inflation that way from, say, 8 per cent to 3 per cent means in the United States losing one trillion dollars' worth of real GNP. A weak economy cuts back

production to reduce inflation, and anything the government does to fight inflation through general fiscal and monetary measures is doing the same thing. There is no magic in government dollars for good or for evil. The government affects total spending; it can bring down the nominal GNP or raise it. What it cannot do is control the way that reduction is split between the lower rates of price increase it wants, and the lower production and employment it does not want.

Putting this differently: every dollar taken off the nominal GNP when the economy is not overheated eliminates about ninety cents' worth of real production to get rid of a dime's worth of inflation. That's what people are talking about, though they won't admit it, when they recommend balanced budgets and cuts in the growth of the money supply. They are saying the economy is too strong and that weakening it is the way to get rid of inflation.

To reach the conclusion that we made the mistake of having excessive stimulation in the budget and in money growth over the last several years one has to argue that we had either too shallow a recession or too rapid a recovery. Not many people would want to argue either of these things for 1975 or 1976 or 1977. To be sure, in the last few months of 1978 the rate of recovery now looks as if it was excessive. The role of excess-demand pockets in the current upsurge of inflation is actually fairly small. It shouldn't have happened at all, but it's not a big part of the story.

Consistent application of fair packaging and labelling legislation would require every proponent of balanced budgets and low money growth to note on the label that according to recent history every point of inflation lost in the United States with this medicine is likely to cost something like \$200 billion dollars in real production. I do not think such a medication would be very popular.

Incidentally, international experience is not different on this score. To be sure, some countries have done a much better job getting rid of their inflation. But they have paid a very high price. In some cases, translated into welfare terms, the price does not seem so high. Employment in Switzerland, for

example, is down 10 per cent from its 1974 high. But that does not mean Swiss unemployment has gone up ten percentage points, because the unemployed people have returned to other countries, to Italy, Spain, or Turkey.

In the case of Germany, much of the improvement in inflation has been accomplished through an appreciation of the currency. That's a great game, but only a few can win, and if everybody tried playing it everybody would lose.

As for the fiscal-monetary cure taken alone, there's a tendency to distinguish between long-run and short-run aspects. The dime on inflation that you get out of that first dollar keeps winding down year after year, true. But just as there are long-run benefits, so there are long-run costs or consequences. The major explanation for weak investment in the United States over the last five years has certainly been the severity of the recession. Note that 1974 registered the highest ratio of business investment to GNP in the whole post-war era in the United States. Inflation did not stop investment. Even the taxes based on inflation did not stop investment. But the recession did, and the worries about recurring recession and instability have kept it weak. In turn, weak investment brings poor growth in productivity, and poor productivity growth tends to worsen inflation.

There may be a misunderstanding of the conservatism of the public today, a belief that the democratic process is suggesting that there is a general willingness to pay \$200 billion a point to get rid of inflation by the hawk cure. I think it is unquestionable that the American people have lost a lot of enthusiasm about government spending and government programs. But there are a lot of intellectual conservatives who not only dislike government spending but also favour the hawk cure for inflation. The non-intellectual conservatives, the men and women on the street telling pollsters how little they like government spending, are also saying they hate recession. They would rather have controls; they would do almost anything to stop inflation, except two things: shoot their grandmothers and have another 1974-5 recession. Unemployment, bankruptcy, the ravages of recession have not

become popular with the voter. The democratic decision is still to keep the economy prosperous.

I submit that the wage-price spiral remains a fundamental source of the inflation of recent years. It is what has kept the inflation going, and it has to be part of the cure.

Let me conclude with what I think the cure is. I think the cure must be a diversified, multi-pronged attack on inflation. I think inflation can be stopped during the eighties with a diversified attack.

One part of it has to be fiscal-monetary restraint, there's no question about that. We must have more discipline on fiscal-monetary policy in the next expansion than we did in the United States in 1978. We just cannot afford to take risks on that inflation flashpoint.

But we also have to remember how expensive the cure is. In order to make it economically efficient and politically tolerable, it's got to be combined with direct pressure on the price level and the cost level. I think we must have an incomes policy, I cannot see a movement out of stagflation except with some sort of constructive incomes policy - maybe a series of them if no single policy will stick.

My own hope would be that we could learn to fashion an incomes policy based on tax rewards and tax penalties. That's not about to happen in the United States. The president is not even about to get his real wage insurance proposal through. But I do not think inflation will go away without an incomes policy.

When you ask if incomes policies work I say yes, they work for a while. The record shows significant contributions of incomes policies in many countries over periods of time. When P.T. Barnum was asked how he got a lion and a lamb to stay in the same cage he replied 'It's easy. All you need is a large reserve supply of lambs.' That's the story on incomes policy. Lambs put in the lion's cage are going to get eaten, but they'll do some good for a while by keeping the lion pacified.

A third part of a proper diversified attack on inflation must involve those areas where the government's microeconomic actions have direct effects on the price and cost structure.

The most obvious of these is the case of indirect taxes. Everywhere in the western world where there are payroll taxes on employers, the evidence suggests that these are really hidden sales taxes on the consumer. The employer passes them on to the consumer because there is nowhere else for them to go. Sales taxes add to prices. Value added taxes, wherever they have been imposed, have had an inflationary impact beyond their direct impact because they feed into escalator clauses and the like. In 1977 the United States took some very serious steps in the wrong direction on this score. To move in the right direction we could get rid of some of our payroll taxes, some of our sales taxes. I think Canada has tried cutting them back. We can try some more.

In a period of budget stringency there is a strong tendency to try to accomplish social objectives with regulatory legislation, telling business to do this, to make that safe, to control environmental costs, and so forth. Again, the consumer has to pay the bill. We have to do some of that, but we must be more careful. We have a lot of floors on prices in the United States, floors on agricultural prices, on pay for workers on government contract, on sugar, through the regulatory process on transportation prices. All these things keep adding to the cost level. They are not one-shot inflation because they get into the cost level and become a habit.

This year's economic program in the United States seems to be the beginning of a diversified approach. I wish Jimmy Carter had reached where he was in October 1978 a year earlier. In my opinion we now have an appropriate degree of fiscal-monetary restraints. We are seeing reasonable attempts to make a semi-voluntary informal system manageable. That won't win them all, but it won't lose them all either, if the government shows it has some means of dealing with non-co-operators with regulatory changes and so on.

I sat in the executive office building for three years while Lyndon Johnson ran a program of jaw-boning, arm-twisting, and ear-stroking. We won some; we lost a lot. The program did not get dismantled, and we did not go for controls. I suspect the apocalyptic view sometimes taken of a particular price and wage issue is overstated by both sides in order to focus on it.

In my view the present U.S. program is not the ideal type of incomes policy. But it puts us a lot further ahead by recognizing some of the regulatory costs for the first time. It recognizes the need to couple the appeal for private price and wage restraint with government restraint, with fiscal and monetary restraint. I'm sorry it did not get started a year earlier and had to wait for the tide to be running against this anti-inflationary initiative.

But I think that program deserves the hope of all North Americans and the co-operation of all U.S. citizens. It's a start to see that inflation has to be fought in a multi-pronged way, to see that it has to be fought because it will get worse if it isn't stopped, to recognize there can be no benign neglect of the inflation problem.

The multi-pronged attack is a tall political order. It steps on the toes of special interest groups. It's difficult and requires discipline - a very scarce commodity in the political process.

Can we run that kind of program politically? I have enough faith in democracy to hope that we can -- with a little education, with a sense that depressions can be enormously costly, and with less of the know-nothingism now sweeping the country, and less too of the rhetoric of 'balance the budget and cut money growth and everything will take care of itself.' With an understanding that there is a common interest in the inflation battle there is a chance that the eighties will be the decade in which we move out of the stagflation swamp.

CURRENT ISSUES IN THE INTERNATIONAL ECONOMY

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The following is the edited transcript of an address to the fifth annual Outlook and Issues Conference of the Ontario Economic Council, held in Toronto, Ontario, 2 April 1979.

In discussing current issues in the international economy let me start with short-term issues. Then I shall turn to some of the longer-term questions.

The number one current short-term issue is obviously what will happen to the price of oil and what effect that will have on the world economy. I'm not going to try to predict to you where the price of oil will be in June or October or December. I agree with Niels Bohr, the famous physicist, that prediction is difficult, especially about the future. Nevertheless, it seems quite reasonable to suppose that the 1979 price of oil on the world market would average at least two dollars more than it was in 1978. Probably that is an optimistic estimate.

But if that is the case the receipts of OPEC will be increased by some \$20 billion. Broadly speaking, each dollar increase in the price of oil raises the revenues of OPEC countries by \$10 billion.

In 1974-5, we all remember, the price of oil went up by an enormous percentage, by about eight dollars in either Canadian or American terms. The increase this year will not be that large, but it will be significant. We therefore ought to look back to the lessons we learned then in the hope of avoiding an experience like that in 1975, when the world economy suffered its deepest recession since the 1930s. An important part of the reason for that recession was the increase in oil prices.

Before we get to the economics of oil prices, it seems to me that the recent experience with oil teaches an important lesson. We've all heard scenarios predicting that in the near future the oil wells would run dry, and many of us have been

fairly complacent about such projections. Most of us felt that the world was not going to run out of oil but that probably the real price of oil would go up gradually but steadily, beginning some time in the 1980s, and some time between 1990 and 2000 other forms of energy supply would take over.

Recent events in Iran and the decisions in Baghdad have reminded us that the vulnerability in the supply of oil is of a different character from the simple supply-demand situation. There is the possibility of political influence over the supply of oil.

Now to go on to the economic effects of the oil crisis. If the price of oil goes up by two to three dollars, the revenues of OPEC countries will rise by \$20 billion to \$30 billion, and their balance of payments surplus will, in the first instance anyway, rise by as much. Before the increase in oil prices the surplus was running at an annual rate of about \$11 billion. Thus we must ask what the consequences would be of such an increase in revenues when initially the balance of payments of this group of countries taken together is about \$11 billion in surplus.

We have to distinguish between those OPEC countries that tend to spend the increase in their receipts, so-called high absorbers, and those that already are in surplus and whose imports will not go up simply because of higher export receipts. In the latter category, the so-called low absorbers, there is first and foremost Saudi Arabia, but also Kuwait, the Emirates, the other Arabian peninsula countries, and, I believe, Libya.

Broadly speaking, the high absorbers and the low absorbers each account for half of the receipts of the oil production of the OPEC countries. Therefore, if OPEC receipts go up by \$25 billion (assuming an increase in the oil price of \$2.50 this year) OPEC imports, with some lag, will go up by \$12½ billion more than they would have risen, and \$12½ billion will be added to the surpluses of the low-absorbing countries.

What would be the impact of this? There are two or three areas to consider. Some people would worry about the effect on the U.S. dollar. But the U.S. dollar has weathered the recent

events successfully on the foreign exchange markets, which have not always been rational in their reaction to an increase in oil prices. Really, there is no reason why an increase in oil prices should tend to depress the U.S. dollar more than other industrial currencies. (There might be one or two exceptions: maybe sterling would strengthen against the U.S. dollar because the United Kingdom is now an important oil-producing country, and since Canada is almost independent in oil the Canadian dollar might strengthen against the U.S. dollar too. But these are conjectures, of course, not predictions.)

To complete the analysis one would have to ask what those OPEC countries that have increased revenues are going to do with them. On what imports will they spend those additional revenues? Or, if they are adding to their surplus, where will they invest?

I do not think the U.S. dollar is going to plummet as a result of the increase in oil prices. I do not expect the dollar's relationship to the French franc, the German mark, the Japanese yen, and so on to be affected significantly by this. I won't try to predict what will happen to the U.S. dollar in relation to the Swiss franc, since I find the Swiss franc incomprehensible.

A second and perhaps more important question concerns the impact of the higher oil price on economic activity. And there are two sorts of effects there. One is an obvious price effect - the cost of an important raw material has gone up, a raw material for which there is no immediate substitute, an import for which the demand is relatively inelastic. So there is an increase, a cost-push, as it were, on price levels of oil-importing countries. One can think of the increase in oil prices, now as in 1973-4, as being similar to a sales tax levied on oil consumption. This tends to increase the price of oil, just as a sales tax increases the price of the products on which it is imposed. But at the same time the tax absorbs purchasing power that would otherwise have been spent on other goods and services, so that in addition to an increase in costs and prices there is an income effect as well.

To the extent that the recipients of the tax spend the

proceeds (in this case the recipients would be the high-absorbing OPEC countries) on additional imports, which of course mean additional exports from non-OPEC countries, aggregate demand in the latter countries will not be affected. As a result, the deflationary pressures on our economies of the rise in petroleum prices will be offset. But roughly half of those additional revenues will be added to the surplus of the low-absorbing OPEC countries, and there will be no significant offset to the contractionary effect on the total demand for the products of the industrialized countries. Even though the contractionary effect will be smaller than in 1974-5, it may still be significant, and ought to be taken into account by policy-makers.

The impact on the dollar I don't think is going to be terribly significant. But the effect on the rate of real economic expansion will occur in a world where expansion since the recession of 1975 has not been satisfactory anywhere except perhaps in my own country. Indeed, the United States is the only country among the industrial nations that has had a vigorous recovery from the 1975 recession. Some people would argue that we have had an excessively vigorous recovery. That issue is being debated south of the border, but it is not a current issue in the international economy.

Now, let me talk about the dog that did not bark, as Sherlock Holmes put it. The dollar has not fallen for several months now. Colleagues whose specialties are not international economics and other friends elsewhere ask me time and again: 'Why isn't the dollar falling?'

From September 1977 until the autumn of 1978 both our dollars declined in value against the rest of the world's currencies, particularly those of the other industrial countries. That episode came to an end in October 1978. What brought it to an end is debatable. But certainly the policy actions and the perceived intentions of the American authorities on 1 November 1978 had an impact on the foreign exchange markets.

Meanwhile, other more fundamental events had occurred. The U.S. dollar had already fallen by roughly 15 per cent. Mean-

while the underlying balance of payments of the United States had been improving, though this was not perceived, or if perceived it was not being acted upon, by participants in foreign exchange markets until 1 November. Since November there has been a remarkable stability of exchange rates. And I cite this partly to bring out a second event in the world economy. The stabilization of the exchange rate of the dollar carries with it a stabilization of the exchange rate of the German mark, the Japanese yen, and the currencies of other industrial countries. (The yen has not only stabilized but also depreciated by several percentage points since November).

With the stabilization of these other currencies which had earlier been appreciating, there has also been an increase in the rate of inflation in these countries. In the period up to 1 November 1978, Germany, Japan, and Switzerland were all benefiting from declining import costs; as their exchange rates went up, the domestic costs of their imports went down, and this helped to hold down the increase in their prices. The year-over-year reports on changes in prices, both wholesale or consumer prices, were extremely low in Japan, Germany, and Switzerland during 1978. For a while, wholesale prices were actually down, year-on-year, in Japan, and they were very stable in Germany. The German inflation rate had fallen to just over 2 per cent on consumer prices; in Switzerland the inflation rate was less than 1 per cent; Japan's consumer prices were rising a little faster than that but still fairly slowly.

Once the exchange rates stabilized, that downward pressure on prices stopped, and suddenly these countries showed higher inflation rates than earlier. That's only natural. It is not possible for all countries in the world to benefit from appreciating exchange rates and downward pressure on their price levels. If one exchange rate goes up, another exchange rate has to go down.

The increase this year in the rate of inflation in Japan, Germany, and Switzerland has policy implications. If the German and the Japanese fiscal and monetary authorities react to this higher rate of inflation by tightening their own fiscal

and monetary policies, they will place the rest of the world in trouble.

If we look at the world economy, still in a short-term context, it is encouraging that after a period of unsatisfactory recovery from the 1975 recession in Europe and Japan the pace of economic activity has now quickened in those countries. Germany's faster rate of economic expansion has affected all of Europe. Meanwhile most signs are that the rate of economic expansion in the United States slowed significantly from the pace in the fourth quarter of 1978. The so-called convergence of rates of economic growth - a code word used by the International Monetary Fund, the OECD, and various other international bodies - seems in fact to be taking place early in 1979. That is a good thing for many reasons. Not only does it have balance of payments implications, which I'll get to, but also it means a higher rate of utilization of capacity and perhaps some decline in the excessive rate of unemployment in Europe. Japan has a peculiar system in which one does not measure unutilized capacity by the employment level, but it seems to be generally agreed that the scope for more rapid economic expansion in Japan is considerable too.

The twin of the stagflation problem, of course, is what is happening to prices, and there one cannot report very good news generally. The U.K., where the situation is now uncertain, did manage to bring down its rate of inflation from near astronomical levels for an industrial country. The United States is trying to introduce an incomes policy, with results still uncertain. Apart from those countries whose currencies are no longer appreciating, most of the European countries appear to be caught up in a wage-price cycle, just as the United States has been. I must say I see no other solution to the type of inflation from which most of our economies have suffered in recent years than some form of incomes policy - different forms for different countries, depending upon institutions and experience. But I have no reason to believe that creating a recession is going to cure inflation. As my colleague Arthur Okun has calculated, for every billion dollars by which you increase nominal GNP, one-fifth of that effect will show up in

prices and four-fifths will show up in the drop in real output.

The implications of this convergence of economic expansion for balance of payments positions is fairly obvious, and I don't have to dwell upon it. The U.S. balance of payments position is improving significantly. The figures for the fourth quarter of 1978, released a few days ago, show a further sharp reduction in the current-account deficit. The trade figures for the month of February were also released recently, and they show a significant reduction in the trade deficit. I'm now leaving out of account the effect of oil, and I think that is justified because if a higher oil price increases the current account deficit of the United States it will probably do the same for most other industrial countries. Therefore, the improvement I see in the U.S. current account position compared to the international positions of the European countries and Japan, will occur even at a higher oil price.

The movement of exchange rates from autumn 1977 until autumn 1978 has been poorly understood. As the dollar fell after September 1977 the first explanation, particularly in Europe, was that Treasury Secretary Mike Blumenthal was talking down the dollar. He had come out of a meeting of the OECD in Paris in May 1977 and made a statement to the effect that it would be desirable if countries with sizeable surpluses did not resist upward pressures on their currencies. Others had been saying the same thing, but when the U.S. Secretary of the Treasury made that statement it was taken seriously by the foreign exchange markets. The falling dollar was blamed on Blumenthal, who, it was claimed, wanted the dollar to devalue.

At that time, in late 1977, the U.S. inflation rate was relatively low. One forgets that in the second half of 1977, when the downward movement of the dollar began, the U.S. inflation rate was only about 4 per cent a year.

A second explanation that came along was the voracious American appetite for oil. That appetite is indeed voracious. There was a big increase in American oil imports in 1977, which accounted for nearly half the increase in our trade deficit that year, which in turn contributed to the enlargement in our current account deficit then. But U.S. oil imports stopped

increasing as Alaska came on stream.

At this point the third explanation arose, with some reason, and that was the acceleration of inflation in the United States, beginning in 1978 and continuing to the present.

It is difficult to know whether any of these popular explanations were valid, since the dollar has stabilized in the face of continuing inflation. I would say that the magnitude of imbalances in current account positions among the industrial countries had a lot to do with the exchange rate movement, and as those imbalances narrow, as they are doing and will probably continue to do in a relative sense at least, one ought to see a continuation of this stability in foreign exchange markets.

An important explanation for the enlarged current account deficit of the United States, and thus for the fall of the dollar, is not encompassed by these three explanations. The major explanation in my view was the sluggish economic expansion in Western Europe and Japan. Along with exceedingly slow increases in industrial output in 1977, the physical volume of imports, or imports corrected for prices, into the major industrial countries was as follows from the fourth quarter of 1976 to the fourth quarter of 1977: France, minus 3 per cent (the import volume actually decreased); Italy, minus 2.6 per cent; United Kingdom, minus 3 per cent; Japan, plus 2 per cent; Germany, plus 3 per cent; Canada, minus 2.7 per cent; United States, plus $5\frac{1}{2}$ per cent. In other words, U.S. imports in physical volume terms increased twice as fast as those in the other major industrial countries. That was in 1977. No wonder the U.S. trade and current account deficits increased.

The next four quarters, from the end of 1977 to the end of 1978, tell quite a different story. Imports have grown much more rapidly in each of the other countries. In the case of France instead of a decline there was an increase of $4\frac{1}{2}$ to 5 per cent. In the case of Germany imports have gone up almost 10 per cent from the fourth quarter of 1977 to the fourth quarter of 1978. In the case of Japan 8.8 per cent, rather than 2 per cent. In the case of the U.K. 14 per cent, rather than falling 3 per cent. The acceleration of economic activity has brought with it an increase in imports, which has benefited

not only the U.S. balance of payments, and possibly also the Canadian balance of payments, but certainly the position of the developing countries.

A word about exchange rates. The U.S. dollar is not very far now, on average, from where it was when the decline stopped at the end of October. It is down a little less than 15 per cent, on an effective rate basis, (an average trade-weighted basis). The Canadian dollar fell by 20 per cent on an effective rate basis. The Italian lire also declined during this period, and the Swedish krone very slightly. The German mark went up by 12 per cent from September 1977 to the present, though a good part, about two-thirds of that 12 per cent, can be accounted for, or offset, by the much lower rate of inflation in Germany than in other industrial countries.

Therefore, Germany's real exchange rate increased very little over the last eighteen months. The Japanese yen is up about 15 per cent, and probably that is an increase in the real exchange rate. The yen had been up much more than 15 per cent but has fallen sharply since November. The other currency to go up is of course the Swiss franc, which rose 26 per cent.

But what I wish to emphasize is that very few currencies went up by a significant amount. Most currencies were relatively stable. The effective exchange rate of the French franc is hardly different from what it was in September 1977. The effective exchange rate of the British pound is up 3 per cent from September 1977, and much of that increase has occurred just in the last few weeks.

The major counterpart of the decline in the U.S. dollar and the Canadian dollar, the currencies that fell most, is the rise in the German mark, the Japanese yen, and the Swiss franc. The countries with rapidly rising exchange rates have also had very large surpluses in their current accounts. The exchange rate movement, which aroused so much discomfort and acrimony in Europe, had behind it a fairly solid, fundamental, basis - slow expansion in Europe and large surpluses in those countries whose currencies were going up in some sort of broad, average trend.

Let me turn now very briefly to the European monetary

system. The latest manifestation of the long desire to unify Western Europe came in the recent decision inspired by Chancellor Schmidt and President Giscard d'Estaing to have the members of the Common Market form a European Monetary System. The proposed system looks rather like the so-called snake, which has existed in Europe for some years now, but has excluded France, Italy, and Ireland, which have all now joined with Germany, Holland, Belgium, and Denmark to form the European Monetary System. They will try to have stable but adjustable exchange rates among themselves. They have created a regional Bretton Woods system of their own. They want to use the discipline of a fixed exchange rate to bring down the rate of inflation in Europe. But they face a dilemma. The members of the European Monetary System have very different rates of inflation, very different social conditions, very different degrees of trade union militancy, and it is not to be expected that they can bring their economic policies and their economic conditions together in the short run.

So it is inevitable that their exchange rates will have to be revised from time to time. The other horn of the dilemma is that if they change their exchange rates too frequently, or engender the expectation that they will do so, then they will lose the discipline they are seeking from fixed rates. They have a difficult problem ahead of them. But the European Monetary System, in my view at least, does not have adverse implications for North America or for the rest of the world - on the assumption, which I think is a plausible one, that countries will not sacrifice economic expansion, economic growth, in order to maintain an exchange rate that is out of line.

I would like now to identify briefly three or four longer-term issues in the international economy.

Everyone is aware that what we used to call the developing countries are by no means a homogeneous group of nations. A dozen or so of them we now refer to as advanced developing countries, or ADCs. These countries have suddenly appeared in the world market for manufactured goods, and they have been extremely successful in exporting industrial products, both to

the older industrial countries and to developing countries. This is a fact of life to which we have little choice but to adapt just as England had to adapt to the industrialization of other countries, although perhaps we can do so rather more successfully than the U.K. did. I see this as a problem because there are pressures in many countries not to adapt but to protect, and to protect is not to promote a harmonious world economy. To exclude the exports of these countries is to neglect the fact that they also contain very rapidly growing markets for the exports of the older industrial countries, a fact often overlooked.

A second longer-term issue is what I would term the management of macro-economic interdependence. All our economies have become much more open in the past two decades. The statistics on trade relative to GNP in almost every industrial country are quite extraordinary. They show a very significant increase in both exports and imports compared to domestic economic activity everywhere. Financial interdependence has also increased. The mobility of labour has increased, as shown by the migration of labour in Europe (at least until recently: one of the costs of the recession of 1975 was that the movement of migrant workers was more or less ended, perhaps temporarily). There is a movement into the United States from countries to the south. This is another form of interdependence with effects both ways, on the host country and on the home country.

Many other forms of interdependence have increased too, but the one I wish to draw attention to is the influence of rates of economic expansion, in particular of real economic growth or the lack of it, between countries. I have already referred to some of the effects of the sluggishness in Europe and Japan; clearly the system of floating exchange rates does not protect us against real economic impacts of one country on another.

Even with floating exchange rates countries will feel real impacts from each other, and a case can be made for managing these impacts by co-ordinating economic policies. The

purpose would be to optimize the performance of the world economy. This proposal needs a lot of work of both a procedural and an organizational character and has to be backed up by substantive analysis.

The reserve currency system is a subject on many people's minds, particularly since the recent decision by the Interim Committee of the International Monetary Fund to ask the Fund's staff and executive directors to study the possibility of implementing a substitution account in the Fund. This would be a facility into which countries could place reserve currencies and in exchange receive special drawing rights or assets like special drawing rights. This also is a longer-term problem. One of the motivations for this type of proposal is the concern that there may be some tendency to diversify out of existing reserve currencies. Whether or not such a tendency exists is an empirical question to which I can give no answer. It may well have happened during the period of the falling dollar in 1977 and 1978. Whether it is still going on or could I do not know, but I see no harm in the movement of the world monetary system in the direction of a more SDR-oriented system. It makes political sense; it also makes economic sense to move toward a more unitary, unified, reserve currency system. But it is hardly a solution to the major problems of the world.

The major problems of the world economy, as I see it, are not essentially systemic. I do not think the international monetary system, or the international trading system, or the international economic system, is somehow at fault as a system.

The real problems arise in individual countries. The real issues are faced by countries in formulating and implementing policies to cope with those problems. To me, the world problem is equal to the sum of its parts, and the parts are economic policy problems in individual countries. Nothing can be solved by the magic waving of a wand to change some system. A solution entails the very difficult political and economic task of deciding what policies are proper, given what is happening in the rest of the interdependent world. Legislators or other policy-makers have to agree and to act, implementing policies

designed to keep the world growing at a decent rate and reducing inflation, so that we can continue to have equity and social peace. I think that's a good way to end: equity, social peace, and growth.

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